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SUBJECT: THE CANADIAN DOLLAR AND INFLATION CONTROL

REF: (A) OTTAWA 1869 (NEW CENTRAL BANK GOVERNOR)

(B) OTTAWA 1600 (CLIMBING CANADIAN DOLLAR)
(C) OTTAWA 0921 (HARPER GOV'T AND CANADIAN BUSINESS)

SUMMARY/INTRODUCTION

SENSITIVE, BUT UNCLASSIFIED. NOT FOR DISTRIBUTION OUTSIDE USG CHANNELS.

¶1. (u) Summary: The consequences of the rapid appreciation of the Canadian dollar's (the "loonie") value to above $1 U.S. for the first time in more than three decades are a topic of daily public discussion in Canada. Bank of Canada Governor David Dodge and other Bank officials have hinted that there is a speculative component in the latest round of appreciation; Finance Minister Jim Flaherty has called on retailers to ensure that the currency's strength fully passes through into lower consumer prices; and economic analysts have raised concerns that the stronger "loonie" is causing structural job losses in the manufacturing sector and reduced export revenues.

¶2. (sbu) Although the Canadian economy is operating above its expected production potential, we see no sign that the Bank of Canada will relent from its 16-year-old prime mission of inflation control. While recent Bank messages appear less focused on inflation than in the past, recent events -- the U.S. economic slowdown, the worldwide tightening of credit markets, and the strong "loonie" - have reduced the Bank's inflation risk assessment. The Bank now expects inflation to moderate to two percent during 2008 without further interest rate increases. With respect to the exchange rate, the Bank's standing commitment is to ensure that market movements are "orderly." END SUMMARY

THE CENTRAL BANK'S PRIME DIRECTIVE: INFLATION CONTROL
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¶3. (u) During the late 1980s and early 1990s, Canada struggled with a complex of economic problems including high public sector deficits, unemployment, and inflation. In February 1991, the GOC and the Bank of Canada jointly agreed on a series of targets for controlling consumer price inflation over a five-year period, and inflation control became the Bank's mandate.

¶4. (u) This policy shift was intensely controversial. Economists debated the optimal rate of inflation, including the possibility of

price stability (zero inflation). Politicians and the general public debated whether any effort to control inflation would be worth the pain involved, or whether economic authorities, including the central bank, should be focused on employment.

¶5. (u) Then-Bank of Canada Governor John Crow - who had advocated inflation targeting - was demonized by the Canadian public and media, and probably as a result, he was not considered by the government in 1993 for appointment to a second seven-year term. Nevertheless, the government's inflation targeting agreement with the Bank was a lasting success. Over the last 15 years, inflation has been contained within a target band of one to three percent, and the agreement has been extended a number of times, most recently in November 2006 for a further five-year period.

THE CLIMBING CANADIAN DOLLAR

¶6. (u) Ref (B) outlines the effects of the steep appreciation of the Canadian dollar since 1993 (by about 60 percent against the U.S. currency). The rise has been driven in large measure by rising prices for exported commodities, particularly oil, but also metals and wheat. While many analysts expected such a dramatic change
Qand wheat. While many analysts expected such a dramatic change
would cause economy-wide problems in this open trading nation, Canada's macroeconomic performance has been smooth and strong.

¶7. (u) Although the "loonie's" appreciation has accelerated job losses in Canada's manufacturing sector, notably in forestry and textiles/clothing, a stronger Canadian dollar has not harmed overall job creation. In September of this year, the official unemployment rate dropped below 6 percent, its lowest level in 35 years, largely due to growth in the resource industries and construction. The Canadian dollar's appreciation has also moderated the country's commodity boom somewhat (as commodities are priced in U.S. dollars),

easing the central bank's job in meeting its inflation targets. Finally, the new affordability of imported machinery is helping companies reinvest in ways that should enhance productivity, a longstanding worry of Canada's economic policymakers.

POLITICAL REACTION

¶8. (u) Although the economy is performing well, the Canadian dollar's rise has prompted concern in Canada's business and economic establishment. Prior to the latest round of appreciation -- which took the exchange rate from around US 93 cents in mid-August to US$1.04 in late October -- several business leaders called for official intervention to contain the dollar's rise and protect Canada's export competitiveness. Consumer groups have complained about Canadian retail prices, notably for vehicles, which have remained significantly above their US equivalents.

¶9. (sbu) On October 23, Finance Minister Jim Flaherty, who has an affinity for populist causes (ref C), publicly urged industry to reduce domestic consumer prices to reflect the increased purchasing power of the dollar. Flaherty may have a mix of political and economic motives: as a politician he wants to deflect consumer anger away from the government and toward retailers, while as Finance Minister he wants to contain the loss of tax revenue due to consumers crossing the border to shop in the United States. Flaherty has also preached the virtues of productivity-enhancing investment to manufacturers.

¶10. (u) Bank of Canada Governor David Dodge remarked on October 21 that the latest round of appreciation has been "abnormally quick and doesn't seem to be related to the domestic factors which would normally lead to that sort of appreciation." Professional opinion among Canadian economists is that fundamentals justify an exchange rate somewhere between US 90 cents and US$1.00, and that recent appreciation may have been driven disproportionately by the climbing price of oil. In its latest Monetary Policy Report (released October 16), the Bank of Canada assumes that the Canadian dollar

should average U.S. 98 cents over the next year. A senior Bank official told EMIN last week that he believes that about U.S. 5 cents of the Canadian dollar's valuation probably represents currency speculation. (At this year's prices, oil and oil products make up around ten percent of Canada's exports).

MONETARY POLICY MESSAGE STAYS THE COURSE

¶11. (sbu) The flood of recent commentary on the exchange rate - coming on top of signs of a U.S. economic slowdown and the tightening of credit markets since August - might have been taken to suggest that Canada's monetary authorities could be ready to change the strict inflation targeting that has guided them since 1991. However, messages from the Bank of Canada so far lend no support to this idea.

¶12. (u) While the central bank's concern about inflation may have moderated over the past two quarters, this is more likely because inflation appears under control than due to any change in the Bank's vigilance. The October Monetary Policy Report devotes little discussion to the Canadian dollar other than as a positive factor in inflation control. The report makes the following key points:

-- Early information for the third quarter suggested that the strong Canadian dollar was leading to a marked reduction in net exports.

-- The credit market tightening since August has added about 25
Q-- The credit market tightening since August has added about 25 basis points to the cost of credit for businesses and households.

-- The slowdown in the U.S. housing sector has been sharper than expected, moderating demand in Canada.

-- Even with all these factors, Canada's economy is now operating about 3/4 of a percent above its production potential, which is above expectations, and consumer price inflation has been somewhat above the 2 percent annual target.

-- High commodity prices are pushing sustained economic growth, corporate profits, and tax revenues. With no change in Canadian interest rates, the Canadian economy would remain in excess demand through to early 2009.

-- However, the core rate of inflation is expected to ease to around 2 percent in the second half of 2008 and stay at that level through ¶2009. The stronger Canadian dollar contributes to keeping inflation under control and has shortened the time frame during which the Bank expects inflation to subside toward the 2 percent target.

COMMENT

¶13. (sbu) While Canadian policymakers are commenting more often on currency issues and their impact on economic structure, this reflects popular discussion and media questions since the Canadian dollar reached -- and exceeded -- parity with its U.S. counterpart. Our reading of more formal messaging from the Bank of Canada and the Department of Finance reveals no sign of change in Canada's commitment to control inflation.

WILKINS